

Letter of Findings: 01-20170935; 01-20170936; 01-20170976
Individual Income Tax
For the Year 2013

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HOLDING

Indiana Auto Parts Manufacturer failed to establish that its activities in developing and producing prototype auto parts constituted qualified research justifying Auto Parts Manufacturer's claim to research expense tax credits.

ISSUE

I. Adjusted Gross Income Tax - Qualified Research Expense Projects.

Authority: IC § 6-3-1-3.5(b); IC § 6-3.1-4-1; IC § 6-3.1-4-2(a); IC § 6-8.1-5-1(c); IC § 6-3.1-4-4; IC § 6-8.1-5-4(a); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435 (1934); *United States v. McFerrin*, 570 F.3d 672 (5th Cir. 2009); *Stinson Estate v. United States*, 214 F.3d 846 (7th Cir. 2000); *Conklin v. Town of Cambridge City*, 58 Ind. 130 (1877); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); I.R.C. § 41(d); Treas. Reg. § 1.41-4(a)(3)(i); Treas. Reg. § 1.41-4(a)(3)(ii); Treas. Reg. § 1.41-4(d); Treas. Reg. § 6001-1.

Taxpayers argue that the Department erred in disallowing research expense credits attributable to specific projects engaged in by the company of which they were shareholders.

STATEMENT OF FACTS

Taxpayers are individual shareholders/owners of an Indiana manufacturing company in the business of providing bent tubing, end forming, and prototyping. The company supplies its products to automobile and heavy equipment manufacturers.

For simplicity's sake, this Letter of Findings will hereinafter designate "Taxpayer" as the manufacturing company because "Taxpayer" is an S corporation with its business income "passed through" to the individual shareholders.

The Indiana Department of Revenue ("Department") conducted an audit review of both Taxpayer's corporate income tax returns and of the shareholders' individual income tax returns. The audit noted that Taxpayer claimed approximately \$30,000 in Research Expense Credits ("RECs") the benefit of which flowed through to the shareholders.

The Department's audit review resulted in the denial of the claimed RECs. Taxpayer disagreed with the decision denying the RECs and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for the protest. This Letter of Findings results.

I. Adjusted Gross Income Tax - Qualified Research Expense Projects.

DISCUSSION

The issue is whether Taxpayer has established that the performance of preliminary activities resulting in the production of its prototype auto parts constitutes "qualified research" entitling it to the claimed RECs.

A. Department's Audit Examination.

The Department's audit report described Taxpayer's business activities as follows:

[Taxpayer] is in the business of fabricating and bending tubing and has been for several years. [Taxpayer] is hired by its customers to produce bent tubing or end formed products of varying dimensions and material make up. This process typically begins with a request for a prototype part which is produced and conf[ormed] to meet the customer's standards before [Taxpayer] enters into a long term contract to manufacture and supply a specified part.

During the years 2013 and 2014, Taxpayer claimed approximately \$700,000 in qualifying research expenses ("QREs") entitling it to approximately \$30,000 in Indiana Research Expense Tax Credits. The audit reviewed the basis for claiming the expenses to determine whether Taxpayer incurred the \$700,000 in expenses and whether it was entitled to the resulting \$30,000 in credits.

The audit report notes Taxpayer's basis for claiming the credits:

[Taxpayer] claimed as research expenses labor, material, and subcontract expenses on 530 work orders and wages of 23 employees for the fiscal year ending October 31, 2013 and 311 work orders and wages of 21 employees for the fiscal year ending October 31, 2014. The research expenses were compiled by [Taxpayer] and provided to the accountant.

The report documents the Department's efforts to obtain original information documenting the claimed expenses.

Contemporaneous documentation was not available for review when originally requested by the auditor, and [Taxpayer] did not provide documentation linking employees' wages to qualifying activities. Therefore, the audit agreed to a sample review of the projects and expenses.

. . . .

[Taxpayer] was asked to 1) provide descriptions of the projects, 2) identify the uncertainty and process of experimentation undertaken to eliminate the uncertainty, 3) identify employees involved in each of the projects, and also 4) provide any relevant project documentation (including but not limited to designs, test results, sales orders, purchase orders, contracts, etc.). [Taxpayer] was also asked to provide an explanation for how it arrived at the qualifying hours for the 5 sample employees. [Taxpayer] provided varying documents for each project including work orders, customer drawings, quote notes, part submission warrants, customer purchase orders, inspection orders, new part checklists, and/or DPAR (Design Process and Assembly Review) notes. [Taxpayer] provided a brief summary of the projects. [Taxpayer] indicated it was uncertain of the fit for each prototype part, however, did not explain the process of experimentation undertaken to resolve the uncertainty.

As a preliminary matter, the Department's audit found that the "general descriptions and work order documents" provided did not provide sufficient evidence to meet the "four-part" test required under IC § 6-3.1-4-1 necessary to establish that Taxpayer was engaged in "qualified research activities."

The audit report indicates that Taxpayer was asked to provide additional supporting evidence. The Department "requested further information on [five] of the sampled projects" In addition, Taxpayer was asked to explain and provide supporting documentation "of how it arrived at the qualifying wages for [five] of the [twenty-one] employees"

In particular, Taxpayer was asked to:

- Explain research project stemming from the original customer request;
- Identify the "uncertainty" associated with each project;
- Describe the process of experimentation employed to resolve the identified uncertainty;
- Identify the alternatives examined to resolve the uncertainty;
- Explain how each of the project's research activities were "undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering."
- Provide contemporaneous documentation such as time logs, calendars, emails, meeting minutes, payroll records, or job descriptions to explain how research hours were calculated for each of the employees under review.

Taxpayer responded "with a general discussion of how the company arrived at the hours for each of the [five] employees" According to Taxpayer, each "[research and development] order we process has the same issue" which begins with the initial customer request. Each customer contacts Taxpayer "with a request to make a prototype part" because Taxpayer "has the expertise and know-how to produce such a part." Once produced, the prototype part is shipped to the customer to assure that it fits in the final vehicle. "If the part does not fit, the customer provides a revised print and the process begins again."

The audit concluded that Taxpayer failed to meet the requirements necessary to justify the claimed expenses but that the expenses associated with those activities were "ordinary and necessary."

[Taxpayer] has been in the business of producing bent tubing parts and end formed product for many years and has several long time employees with education and experience in the business. [Taxpayer] is hired by its customer to produce prototype parts as a reputable manufacturer of bent tubing and end formed products. [Taxpayer] may be uncertain as to the exact design and material make-up of the tubing, but [Taxpayer] is certain of its capability to produce such a part. The activities described by [Taxpayer] do not meet the definition of qualified research under the provisions of § 174 of the Internal Revenue Code. The activities are the result of the application of common, commercially available, proven and accepted manufacturing principles (§ 162 activities) or the adaptive variations of same through the use of employee experience and accumulated work site expertise. [Taxpayer] is simply doing what is required to be done in the normal practice of tube bending and end forming. The costs are ordinary and necessary business expenses subject to the rules of IRC §§ 162 and 263(a).

B. Taxpayer's Response and Protest.

Taxpayer argues that it routinely engages in research and development activities in the production of its prototype parts and that it is entitled to claim credits for expenses associated with those activities. Taxpayer explains its process:

The customer will provide original drawings that may or may not be complete and [Taxpayer's] engineers will review to determine if the parts can be made per the print. Often the print is provided with a request for quote and sometimes we just get a print to review because the problem at hand is urgent. It is possible that many messages and/or phone calls are made with the customer before a print is drafted by the customer and is ready for further review. This is when a [Design Process and Assembly Review] is typically conducted, (but there are times when prototypes are shipped before the [Design Process and Assembly Review]) and all aspects of the part are reviewed by quality, engineering and sales personnel. This review includes tolerances, performance requirements, assembly issues etc., and possible improvements that affect these areas and also cost. At this point the parts are ready to be produced. Once parts are completed and inspected, they are delivered to the customer for assembly. Sometimes the parts do not fit because of issues on the vehicle itself. Maybe the connections points are not correct. There may be some other part interfering. In these cases corrections will have to be made to the design and new parts developed. In some cases the part may fit but because of other issues on the assembly line they may not be able to be assembled as planned. If the parts do fit and can be assembled then they must survive actual life testing for hours and application. If there are failures at this point then the process is started over.

Taxpayer summarizes that its entire process of producing prototype parts is "one of trial and error." If the original prototype design fails to meet specifications, "other options are tried until a successful design is found" because "[a]ll parts have uncertainty for fit, function, assembly, life testing, [and] cost" According to Taxpayer, its activities "expand knowledge of the skilled professionals in the fields of hydraulic circuits, the influence of tube geometry on pressure, the effect of velocity on suction lines, the effect of fluid velocity on hydraulic lines, and pressure relief methods"

Taxpayer also provided a list of five employees involved in preparing the prototypes, their job titles, and the grounds for classifying the associated labor costs as qualifying expenses.

- **Product Development Assistant Manager.** According to Taxpayer, the assistant manager calculates the part length and arranges to purchase the required materials if the materials are not currently in Taxpayer's inventory. Once parts are shipped, the assistant manager will confirm delivery. Taxpayer states that all of the assistant manager's time is spent on research and development activity.

- **Purchasing Manager.** The purchasing manager worked to assure that materials necessary were available for each project. Taxpayer explains that it may be "difficult to procure the materials within the time

requirement stated." Taxpayer provided emails to buttress its argument that the purchasing manager spent two to three hours each week on research and development activity.

- **Class A Fixture Builder.** This employee "worked in [Taxpayer's] tool room where he worked on end form tools, dies, clamps, punch fixtures, ga[u]ges" Taxpayer provided a copy of its research and development project list.
- **Sales Manager.** The sales manager was the "main sales and customer service contact for all [Taxpayer's] customers. The sales manager was responsible for "estimating and quoting" and often participated in meetings in order to "advise on the cost of the part and how to take cost out." Taxpayer supplied a list of meetings the sales manager attended along with emails directed to the sales manager.
- **Manufacturing Engineer.** Taxpayer explained that the manufacturing engineer "worked on tooling, fixture and ga[u]ge designs for [research and development] activities."

Taxpayer concludes that the information provided justifies Taxpayer in claiming the \$30,000 credit.

C. Statement of Law and Burden of Proof.

1. Burden of Proof.

Tax assessments are *prima facie* evidence that the Department's assessment of tax is presumed correct; the taxpayer bears the burden of proving that the assessment is incorrect. IC § 6-8.1-5-1(c); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

IC § 6-3.1-4-4 provides that, "'Research expense tax credit' means a credit provided under this chapter against any tax otherwise due and payable under [IC 6-3](#)." Similar to deductions, exemptions, and exclusions, tax credits - such as RECs - "are matters of legislative grace." *Stinson Estate v. United States*, 214 F.3d 846, 848 (7th Cir. 2000). The taxpayer who claims the tax credit is required to retain records necessary to substantiate a claimed credit. Where such a credit is claimed "the party claiming the same must show a case, by sufficient evidence, which is clearly within the exact letter of the law." *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96, 100-01 (Ind. Ct. App. 1974) (citing *Conklin v. Town of Cambridge City*, 58 Ind. 130, 133 (1877)).

Citing *Stinson Estate*, the circuit court in *United States v. McFerrin* summarized that "[t]ax credits are a matter of legislative grace, are only allowed as clearly provided for by statute, and are narrowly construed." *United States v. McFerrin*, 570 F.3d 672, 675 (5th Cir. 2009). See also *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934) ("Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefore can any particular deduction be allowed.")

2. Indiana Research Expense Credits.

For income tax purposes, Indiana follows the federal tax scheme with certain modifications. IC § 6-3-1-3.5(b). Indiana provides tax credits outlined in [IC 6-3.1](#) which a taxpayer may claim to reduce its taxable income. One of the tax credits is the "Indiana qualified research expense" tax credit under IC § 6-3.1-4-2(a), which states that, "A taxpayer who incurs Indiana qualified research expense in a particular taxable year is entitled to a research expense tax credit for the taxable year." IC § 6-3.1-4-1 defines the credit. In part, this statute - in effect for the taxable years in question - provides:

"Indiana qualified research expense" means qualified research expense that is incurred for research conducted in Indiana. "Qualified research expense" means qualified research (as defined in Section 41(b) of the Internal Revenue Code as in effect on January 1, 2001).

As a basis for arriving at its conclusions, the audit cited to I.R.C. § 41(d) which defines the term "qualified research" as research:

1. [w]ith respect to which expenditures may be treated as an expense under section 174[;]
2. [w]hich is undertaken for the purposes of *discovering information* which is technological in nature (also known as the Discovery Test)[;]
3. [t]he application of which is intended to be useful in the development of a new or improved business component of the taxpayer; and

4. [s]ubstantially all of the activities which constitutes elements of a process of experimentation for a qualified purpose. (*Emphasis added*).

Treas. Reg. § 1.41-4(a)(3)(i) (T.D. 8930) states:

For purposes of section 41(d) and this section, research is undertaken for the purpose of *discovering information* only if it is undertaken to obtain knowledge that exceeds, expands, or *refines the common knowledge* of skilled professionals in a particular field of science or engineering. (*Emphasis added*).

This regulation then goes on to state "research is not undertaken for the purpose of discovering information merely because an expenditure may be treated as an expense under section 174."

Treas. Reg. § 1.41-4(a)(3)(ii) (T.D. 8930) defines common knowledge:

Common knowledge of skilled professionals in a particular field of science or engineering means information that should be known to skilled professionals had they performed, before the research in question is undertaken, a reasonable investigation of the existing level of information in the particular field of science or engineering.

3. Research Expense Credit Documentation.

In order to obtain the benefit of the RECs at issue, both Indiana and federal law require that a taxpayer maintain and produce contemporaneous records sufficient to verify those credits.

As authority for its decision, the audit cited to Treas. Reg. § 1.41-4(d) (TD 9104) which provides "A taxpayer claiming a credit under section 41 must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit." In addition, the audit cited to Treas. Reg. § 6001-1 which states:

Any person required to file a return of information with respect to income, shall keep such permanent books of accounts or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such persons in any return of such tax or information.

The audit also cited to Treas. Reg. § 1.41-4(d) (TD 8930) which provides as follows:

No credit shall be allowed under section 41 with regard to an expenditure relating to a research project unless the taxpayer - (1) Prepares documentation before or during the early stages of the research project, that describes the principal questions to be answered and the information the taxpayer seeks to obtain to satisfy the requirements of paragraph (a)(3) of this section, and retains that documentation on paper or electronically in the manner prescribed in applicable regulations, revenue rulings, revenue procedures, or other appropriate guidance until such time as taxes may no longer be assessed (except under section 6501(c)(1), (2), or (3)) for any year in which the taxpayer claims to have qualified research expenditures in connection with the research project; and (2) Satisfies section 6001 and regulations there under.

Moreover, Indiana mandates that every person subject to a listed Indiana tax keep books and records, including all source documents "so that the [D]epartment can determine the amount, if any, of the person's liability for that tax by reviewing those books and records." IC § 6-8.1-5-4(a).

D. Conclusion.

Taxpayer describes a routine process by which it exercises its long-standing experience and expertise - through what is essentially a trial and error process - to produce prototypes which meet its customers' needs and specifications. However, there is little evidence that Taxpayer is "discovering new information which is technological in nature" or that the production of the prototypes results in a "new or improved business component" I.R.C. 41(d). To the contrary, the project descriptions Taxpayer provided illustrate efforts to integrate long-standing hydraulic, metallurgic, and industrial manufacturing principles. Although the development and production of each prototype may well be sophisticated and complex, each prototype is simply an adaption of existing technology, know-how, and materials designed to fit the needs of its customers. The Department is unable to agree that the Taxpayer has met its burden under IC § 6-8.1-5-1(c) of establishing that the Department's assessment was "wrong" or that its claim to the credits falls "clearly within the exact letter of the law." *RCA Corp.*, 310 N.E.2d at 100-01. The Department agrees with the audit report's conclusion that expenses

associated with the development and production of the prototypes are "ordinary and necessary."

Nothing in this decision should be construed as minimizing Taxpayer's expertise or diligence in developing the prototypes. However, in evaluating its own qualification for the tax credit, Taxpayer mistakenly conflates diligence, complexity, institutional experience, and its own competence with "research undertaken for the purpose of *discovering information* . . . to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering." Treas. Reg. § 1.41-4(a)(3)(i) (T.D. 8930).

The Department is also unable to agree that Taxpayer has provided sufficient information to establish that it can provide a substantial factual basis for the claimed credits. Although Taxpayer has provided estimates and secondary evidence of the time its employees engaged in the development of prototypes, there is insufficient evidence of the detailed, contemporaneous documentation necessary to substantiate the claimed expenditures. As set out in Treas. Reg. § 1.41-4(d) (TD 8930):

No credit shall be allowed under section 41 with regard to an expenditure relating to a research project unless the taxpayer - (1) Prepares documentation *before or during the early stages* of the research project, that describes the principal questions to be answered and the information the taxpayer seeks to obtain to satisfy the requirements of paragraph (a)(3) of this section, and retains that documentation on paper or electronically.

(*Emphasis added*).

The Department concludes that Taxpayer's activities in developing prototype parts do not constitute "qualified research" and that there is insufficient documentation necessary to establish that its labor costs were directly related to the claimed activities.

FINDING

Taxpayer's protest is respectfully denied.

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